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Evolving international supervisory architecture: Design, rationale and policy reform

Saibal Ghosh¹

I. INTRODUCTION

The need for an international supervisory framework arises from the globalisation of banking business – the fact that ‘the jurisdiction of national regulators is smaller than the geographical business area of regulated financial institutions’¹ (Goodhart *et al.*, 1998)¹. This global reach of domestic business and *vice versa* has systemic implications for both host and home countries. With greater access to international markets being ensured by recent international initiatives, domestic / international financial institutions, national supervisors, investors and rating agencies are driving the development of global standards based on international benchmarks and best practices. Ongoing international efforts towards development of minimum standards and harmonization have come into focus following the renewed interest by policy makers in bank soundness. The reasons for the same are not too far to seek. Driven by the twin forces of liberalisation and innovation, the financial landscape has witnessed a virtual metamorphosis over the last three decades. This has resulted in substantial increase in the importance of the financial sector: permitting the channelisation of a greater quantum of investible resources and their allocation into high productivity outlets, promoting faster routes of growth and sounder economic development. On the flip side however, this transformation of the financial marketplace has extended and tightened linkages across markets and institutions, increased the uniformity of the information set available to economic agents and encouraged greater similarity in the assessment of information. This, in effect, has meant that weaknesses in the financial system can have serious and far more disruptive economic ramifications than was previously the case and engender

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contagion effects extending well beyond national boundaries (Crockett, 2001)². Evidence in support of the same both at the international and national levels have been quite abundant. The Mexican crisis of 1994-95, the East Asian crises of 1997-98 and the more recent crises in Argentina and Turkey are ample testimony to this fact. At the national level, the banking crises in Nordic countries in the 1980s and 1990s, the problems in Philippines and Korean banking systems in the 1990s (and the near panic at the time of the LTCM affair) and the financial bubble in Japan whose costs are felt even at present deserve mention, for which the weaknesses in the application of prudential standards by banks and the inefficacy of the supervisory framework were cited as one of the main causes (Table 1).

In the absence of any international financial regulatory body with a mandate from the nations, the Basel Committee of Banking Supervision (BCBS) from the G-10 countries has been pro-actively engaged in the task of developing standards and enhancing coordination and co-operation amongst national supervisors.

Efforts at harmonisation in banking regulation and supervision have been rendered overtly complex by the diverse range of practices in implementing capital adequacy standards, loan loss classification and provisioning, differences in the legal and institutional frameworks and the varied accounting standards and fiscal regimes in which banks in different countries operate. One basic duality is the broad division of the international banking system into those banks, which have been following such standards (and thus, those which conform to 'international best practice') and those that have only recently begun aspiring towards attaining such standards. This duality has, in its wake, led to the call for development of differential standards for sophisticated and less sophisticated banks, internationally active and domestically active banks and as a corollary, to developed economies and developing/emerging/transition economies. The forerunner of banking standards, the capital Accord of 1988 made a distinction between internationally active banks and other banks, while the New Capital Accord speaks, in addition, of a class of sophisticated banks to which international standards could be applicable.

The work of the Basel Committee, which has taken a lead in the promotion and harmonisation of banking standards, has focused primarily on G-10 countries and their internationally active banks. Such a structure tends to lead to a sort of ‘Stackelberg equilibria’ wherein decisions based on practices in developed countries spill over onto emerging countries. Given that national circumstances in developed economies are often quite at variance with those in emerging economies, this might engender a Pareto-inferior outcome for the latter. The reasons for the G-10 concentric structure of bank supervision effort at the international level are not far to seek. First, it has been argued that over 80 per cent of global banking assets rest with banks incorporated in these countries. Consequently, supervisory focus of banking systems in these countries would need to be a priority agenda. Second, with state-of-the-art information technology being used by banks in these countries, it was believed that a pro-active approach to banking supervision in these countries would necessarily stave off any failures and also addresses the dangers of contagion arising thereof.

Table 1: Costs of Financial Crises

Country	Period	Cost (percent of GDP)
Argentina	1980-82	55
	2001-	2
Chile	1981-86	42
Finland	1991-94	11.2
Norway	1987-93	8.0
Indonesia	1997-98	55
Japan	1990-99	24
Malaysia	1997-98	16.4
Mexico	1994-97	19.3
Philippines	1981-87	7
South Korea	1997-98	28
Thailand	1997-98	34.8
USA (S&L)	1984-91	3.2
Turkey	2000-	30.5

Source: Caprio and Klingebiel (2003).³

While these facts might have had a fair degree of credibility in an autarkic world, the inference may not be as sacrosanct at present. Recurring crises over the past two decades in both the developed and developing world have provided graphic evidence of the fact that, given the globalisation and universalisation of banking operations, the onset of banking crises can impact the banking systems in

both the home and host countries in equal measure, either directly or even indirectly, through contagion effects. And since banking crises are more difficult to accurately predict and have far more devastating effects on the macro-economy (Goldstein *et al.*, 2000)⁴, proactive supervision of banks in developed economies while necessary, is not sufficient to prevent failures. And increasingly, with both international and domestic banking systems coming under the same regulatory umbrella and the growing interest in adoption of international standards being shown by the non G-10 countries, the distinction between 'internationally active' versus 'domestic' banks, on the one hand, and 'sophisticated' and 'less sophisticated' banks, on the other, could cease to have less relevance than in the past. However, while banking systems across countries have exhibited an element of convergence in the adoption of capital standards, the harmonisation in the institutional, legal and fiscal infrastructure in different countries has not materialized as yet. For instance, a survey conducted for 129 countries participating in the ninth International Conference of Banking Supervision showed that in 1996, more than 90 per cent of the 129 countries applied Basel-like risk-weighted capital adequacy requirements (Goodhart *et al.*, 1998)⁵. The approach taken by several developing countries has been not to call for differential standards, but to seek a greater transition time to evolve to attaining these standards and to seek a degree of flexibility in the rules governing best practices, which internalize country-specific features. In fact, several supervisory authorities have argued for the case that national supervisors may be given discretion to implement the new Accord, in a phased manner by banks, which are not internationally active and are engaged predominantly in traditional banking. What needs to be sought is a greater say by the developing countries in transnational efforts in the framing of the harmonised standards (regulation) and the monitoring of their implementation (supervision) (see, for instance, the discussion in Davies *et al.*, 1999).⁶

II. THE INSTITUTIONAL FRAMEWORK

There are two particular types of government networks that are most relevant to global economic issues. The relatively formal type of network is

composed of trans-governmental regulatory organisations. The second, less formal type of network is formed through agreements between domestic regulatory agencies.

The Basel Committee on Banking Supervision (BCBS) serves as a perfect example of the more formal type of network. The central bank governors of the G-10 countries established the Basel Committee in 1975. As the name suggests, this is only a committee of the G-10 countries (which includes Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom and United States), which was constituted by the Central Bank Governors. The BCBS is not an international organisation and its constituents are not member states, but representatives of their respective supervisory organisations and central banks. It has no legal standing, lacks a formal charter of incorporation, cannot enforce its contracts and its decisions do not have legal backing (See, for instance, Alexander, 1997)⁷. Instead, it exploits its links with the national supervisors and the regional groupings to propagate and ensure compliance. It has limited budgets and staff and no headquarters of its own, with the secretariat being located on the premises of an international organization, the Bank for International Settlements (BIS). This umbilical cord gives the BCBS surrogate international status but in actuality, the BCBS is independent of the BIS and its decisions are not required to be ratified by the latter. One probable reason why the two have not integrated is the fact that the BIS is a club of central banks, whereas recent evidence in several countries is a pointer to the fact that the banking supervision function, especially in developed economies, is being divested with a separate agency (Courtis, 2004)⁸.

Despite the fact that the Committee is entirely G-10 centric in composition and has only recently increased its consultation with other non-member countries, it has acquitted its role as a standard-setter for the rest of the world fairly successfully. This is attributed to the approach of 'flexibility' and 'national discretion' (Musch, 1997)⁹, but then this is possibly the only approach which could have evolved, when the standards are being put out by a 'club', which has limited legal mandate across nations.

Even though supervisors are implementing the standards of the Basel Committee across the globe, this has not mitigated or prevented financial crises (BIS Annual Report, 2001)¹⁰. One of the reasons ascribed for this is the failure of national supervisors to apply international best practices and the failure of the international community to monitor the compliance of countries with these practices. The view from the G-10 as enunciated by Davies (2000)¹¹, is that, 'there is a need to enhance supervision, particularly in economies open to capital flows, and to strengthen compliance with internationally agreed best practices'. He argues that the club-like approach of the BCBS, which depends upon a 'gentlemanly compliance' with its rules and provides for a peer review based on informal contacts, breaks down when some members of the club 'do not apply the rules or where there are marked inconsistencies in the way countries apply them'. This failure, in his opinion, is attributed to the fact that 'the groups of supervisors themselves do not have the basis on which to enforce rules among their voluntary membership... the BCBS has tried hard...to reach out beyond its membership, but does not have the mandate to do so. So, the last two years have seen a growing, *albeit* far from complete acceptance by supervisors ... that the standard setting role of these bodies needs to be complemented by assessing compliance with these standards, and these arrangements need to go beyond peer review, which has been only modestly successful'.

While standard setting has and disseminating international (read G-10) best practice has been the major contribution of the BCBS, it has not been inclined to assume the role of monitoring implementation, pleading a lack of resources and mandate for the purpose. It could even be argued that the BCBS was not designed for this role, because its initial approach had been confined to designing minimum standards, the application of which was intended to be a national choice. The move from coordination and cooperation to harmonisation and synchronization is both recent and subtle. In the earlier approach, enforcement of standards was a national choice, and, in part, influenced by peer pressure. Increasingly, however, enforcement of the Basel standards is being influenced through the surveillance mechanism of the IMF. The IMF and the World Bank

have been closely involved with the recent work of the Basel committee, both in designing standards and in monitoring country compliance with the same (for an analytical account of the issues involved in the design of the evolving financial architecture, see Ahluwalia, 1999)¹². This is most evident in the role being played by them in the development, promotion and application of the framework of the *Core Principles for Effective Banking Supervision*. These institutions were instrumental in the design of the framework, and also in the development of the revised assessment methodology for quantifying the compliance and making cross-country comparisons. However, their most significant contribution to the *Core Principles* exercise will be that of the external assessor for member countries of their compliance with the *Principles*, which is being undertaken under a broad 'financial stability' objective. Mention may be made that the Financial Sector Assessment Programme (FSAP) was launched jointly by the IMF and the World Bank in May 1999. The FSAP has been designed to address several issues, including the need to focus on and strengthen the early detection and identification of financial sector vulnerabilities, assess observance and implementation of standards, and to develop appropriate policy responses to weaknesses in financial systems. Assessments under the program encompass a wide range of issues including the macroeconomic environment, the regulation, supervision and soundness of financial systems, financial markets, systemic risks in payment systems as well as institutional and legal arrangements for crisis management (Sundararajan *et al.*, 2001).¹³

Against this background, it may be noted that the scope of IMF surveillance have been expanding from exchange rate policies and structural areas into financial sector policies (banking supervision, deposit insurance and financial sector regulation). One of the reasons behind this shift is the increasing incidence of financial crises, in terms of breadth, severity and frequency (Lindgren *et al.*, 1996)¹⁴. In particular, the Asian crises have focused attention on the potential for external crises to be precipitated not only by traditional macroeconomic failures, but also by structural weaknesses in the financial sector, aided by lax supervisory practices. And, as a part of this, the IMF has been monitoring country compliance

with international standards in this field. A recent report which evaluated the Fund's Surveillance, recommends that " ...outside the Fund's core areas - monitoring international standards should to the maximum extent possible be delegated to other international institutions or associations with the necessary expertise, with the Fund, because of its existing surveillance role, acting as a clearing house for information (IMF, 1999)¹⁵. This is a view shared by Davies (2000)¹⁶, who, in his discussion of the international compliance assessment work, observed that 'in the case of banking supervision....there are some doubts whether the International Financial Institutions (IFIs) have the records they need to complete the job.'

Despite these reservations about the capacity and mandate of the international financial institutions to do this job, recent developments however indicate that the role of the Fund in the exercise of financial sector surveillance (especially bank supervision and regulation) would only be increasing in the coming years (Mohammed, 2001¹⁷; Reddy, 2003¹⁸). As mentioned before, the critical role assigned to the IMF/World Bank in monitoring country compliance with the *Core Principles* and its integration with the FSSA/FSAP is one. Skeptics have however observed that it might be difficult for the IMF and the World Bank combining their role as policy adviser with that of impartial assessor (Evans, 2000)¹⁹. While the positive fallout of public assessment of compliance remains unquestioned, especially for rating agencies, supervisory authorities, standard-setting bodies, besides the Fund and the World Bank, not to mention their utility to the national authorities in designing and carrying through programmes to strengthen financial systems, 'the full benefits from publication [can] only be obtained when there is a critical mass of countries agreeing to publish; and if the assessment contains enough details and judgement for comparable quantitative as well as qualitative conclusions to be drawn' (Evans, 2000)²⁰. In view of the above, in recent times, demand is also being placed upon the Fund to develop macro-prudential indicators (MPIs) derived from the aggregation of institutional data in the financial sector (Evans *et al.*, 2000)²¹. These MPIs are expected to eventually serve as benchmarks for purposes of cross-country comparability and hence

feedback into the standard-setting exercise. While such activity is underway, the scope of MPIs is being widened to encompass what are termed as Financial Soundness Indicators (FSIs). While MPIs seek to provide an assessment and monitoring of the strengths and weaknesses of the financial system, FSIs are aimed at monitoring the health and soundness of financial institutions and markets and of their corporate and household counterparts. Two sets of FSIs have been proposed, a 'core' set, which is broadly comparable across countries, and an 'encouraged' set, which is more country-specific in nature. The FSI data set therefore are aimed to serve two purposes: first, it seeks to develop a set of indicators that are broadly comparable across countries (the 'core' set), which is possible if countries adhere to internationally agreed prudential and accounting standards, and second, it allows for internalization of country-specific vulnerabilities by promoting the development of an 'encouraged' set of indicators. Unlike the MPIs therefore, this seeks to avoid the 'one-size-fits-all' approach and provide flexibility in the selection of indicators (Sundararajan *et al.*, 2002)²².

A practical problem in applying international standards of supervision to developing markets is that these standards need to be tailored to suit country-specific characteristics. For example, the Basel Committee standards for prudential norms and supervision of commercial banks were designed for banks operating in industrialised countries with developed financial markets and efficient legal systems, which could pose problems if applied to developing markets where financial markets are not so well-developed. Similar problems are likely to arise in other areas where standards already exist such as the operation of securities markets and in insurance. With the composition of these standard setting bodies being weighed in favour of industrialised economies, recognising specific features of developing country markets is at a premium.

To sum up, the efforts to upgrade the regulatory and supervisory systems in developing country markets are likely to result in greater transparency and flow of information, resulting in improvements in the functioning of financial markets. However, the argument would need to be treated with caution. First, the

introduction of a sound supervisory system is no guarantee against a financial crisis – crises in various developed country markets with otherwise sound supervisory setup is ample testimony to this. Second, there is a growing body of thought that opines that the focus of supervision should move away from prudential norms and towards enforcement of comprehensive risk management systems in banks. Supervision would then focus on the adequacy of risk management systems in each bank. However, not only is it utopian to define a ‘common international standard’ for such an approach, but the fact also remains that risk management practices differ widely across the developed and developing world: a ‘sophisticated’ approach for developing country banks might turn out to be ‘mechanical’ for industrialised country institutions.

The UN Committee on Development Planning mooted the creation of a World Financial Organisation - a supra-national body exercising supervisory powers over the financial sector. The G-7 countries opted for a more modest alternative of bringing together national authorities of the G-7 countries and other major international institutions and other concerned institutions in a Financial Stability Forum (FSF), with representatives from IMF, World Bank, Basel Committee, IOSCO, IAIS and three representatives from each of the G-7 countries. Developing countries however have not been included in the Forum at present though it is expected to include some emerging economies at a subsequent stage.

Meanwhile, current rules of global finance have exacerbated injustice between income groups through off shore financial centers (OFCs). Several jurisdictions across the world offer low taxation and high confidentiality that are mainly geared towards high net-worth individuals. It has been estimated that, for selected OFCs, on balance sheet OFC cross-border assets reached a level of US \$4.6 trillion at end-June 1999 (about 50 percent of total cross-border assets), of which US\$0.9 trillion in the Caribbean, US\$1 trillion in Asia, and most of the remaining US\$2.7 trillion accounted for by the international financial centers, namely London, the U.S. International Banking Facilities (IBFs), and the Japanese Offshore Market or JOM (IMF, 2000)²³. The supervisory standards in these OFCs vary from non-existent to first-class (IMF, 2003)²⁴. The better-regulated centers

increasingly see their own self-interest as being to achieve full compliance with international regulatory standards. The Financial Action Task Force (FATF) has explored ways to halt criminal money laundering through off-shore finance and the OECD Committee on Fiscal Affairs has since 1998 undertaken some initial steps to combat tax evasion in these centers. The Financial Stability Forum, through its Working Group on Off-shore Centres, is beginning to give a strong push in this direction and devising incentives for compliance.

Thus, the evolving scenario for international supervisory arrangements is poised to have two major components:

- i) The 12 member Basel Committee for Bank Supervision which represents the developed world, and which does not have any international mandate for the development of standards but has been doing so successfully by partly following the democratic process of consultation;
- ii) The International Monetary Fund (and the World Bank), which have a wide membership, but the decision making process tends to be weighed in favour of the developed countries (Griffith-Jones and Kimmis, 2001)²⁵. These institutions are being increasingly involved in the enforcement of the Basel standards through the exercise of assessing country compliance with the *Core Principles* (and thus potentially the rating of supervisory regimes).

The emerging transnational supervisory arrangements are set to be dominated by two bodies, with convex combinations of democratic and representativeness. Of course, the regional association of bank supervisors could also emerge as a prominent player in the standard-setting exercise by its channels of interaction with the BCBS, but this depends on how well these are organized and activated in the coming years. And, with consolidated supervision being of major concern to bank supervisors and the trend towards creation of 'super-regulators', co-ordination with the International Association of Insurance Supervisors (IAIS) and the International Organisation of Securities Commissions

(IOSCO), which are also clubs like the BCBS, but have wider membership which include the developing countries, will also be important components of the framework.

Since 1996, the BCBS, IAIS and IOSCO have convened a Joint Forum on Financial Conglomerates to promote cooperation between banking, securities and insurance supervisors, given that global financial co-operation increasingly operate across the three sectors. In accordance with its 1996 mandate from its three parent organisations, the Joint Forum reviews various means to facilitate the exchange of information between financial supervisors within their own sectors and between supervisors in different sectors. The Joint Forum also examines ways to enhance supervisory coordination and is working on developing principles towards the more effective supervision of regulated firms within financial conglomerates. Another initiative along these lines, the Year 2000 Network – a creation of the Basel Committee, the BIS Committee on Payment and Settlement Systems, IOSCO and IAIS-aims to ensure a high degree of attention to Year 2000 issues within the global financial supervisory community. The Year 2000 Network shares information regarding regulatory and supervisory strategies; discusses contingency measures, and serves as a contact point for national and international private sector initiatives.

These trans-governmental regulatory networks are engaged in a new kind of international law making which is not treaty-based, but rather is rooted in agreed practices that are shared among the networks' members. There are no binding treaties-these practices are, in a sense, like free software downloadable from the Internet. The 'nationalisation' of international law occurs when practices shared by the networks become institutionalized within individual member states.

Another trans-governmental governance of global finance has emerged in recent years through the World Trade Organisation (WTO). The Uruguay Round of intergovernmental trade talks (1986-94) produced the General Agreement on Trade in Services (GATS), which extended multilateral liberalisation of international commerce, *inter alia*, to finance. Since 1995, a WTO Committee on

Financial Services has overseen the operation of GATS in respect of finance. In 2000, the WTO launched further multilateral negotiations on trade in services, including in the financial area. The schedule of specific commitments of each Member involves a positive listing of sectors/sub-sectors and modes of supply where the Member desires to undertake specific commitments. Those, which are not listed, are not subject to any commitments. Besides, even in the listed sector/sub-sector and any particular mode, Members may keep the commitments as 'unbound', which implies no commitments. In the listed sectors/sub-sectors and modes of supply, where they take some commitments, Members can schedule some limitations on market access, national treatment and on additional commitments as permitted under relevant provisions of GATS. Thus, there is considerable flexibility provided to Members under this approach. Some developed countries have been advocating the inclusion of prudential norms within the ambit of GATS. Such commitments, once included, are likely to have two major fallouts: first, it would be binding on countries to comply with them within their national jurisdictions, and secondly, it would be irreversible.

The more informal type of trans-governmental network is created through agreements between domestic regulatory agencies. The Memorandum of Understanding (MoU), the fastest growing international legal instrument in the last decade or so, serves as the basis for this type of network. MoUs, in essence, are agreements between regulators in specific and discrete subject areas that do not carry legally binding burdens. Representative examples of MoUs come from two US regulatory agencies-the Securities and Exchange Commission (SEC) and the Justice Department. The proliferation of MoUs between regulatory agencies results from their flexibility and speed-they are frequently informal in tone, often avoiding legalistic language, while specifying modes of cooperation, information sharing and establishing a framework for ongoing networks.

III. IMPLICATIONS FOR POLICY REFORM

A surprising feature of the evolving arrangements is that despite their gracious inclusion in the bits and pieces, developing countries remain on the fringes of the transnational arrangements. Flagging this as an 'over-arching' issue

in the arrangements of financial co-operation in the new millennium, Jalan (1999)²⁶ has succinctly observed 'the recent moves to involve developing countries more closely in the discussions on the New Financial Architecture are, therefore, welcome. But these efforts have not yet gone far enough. The institutional arrangements for decision-making on the new financial architecture still remain too heavily weighted in favour of industrial countries'.

Given the increasingly shared concern for some degree of convergence in standards and the attempts being made to emulate international best practices, bank supervision will remain centre-stage for some time. While the consultative process which is being followed by the BCBS and the voluntary adherence of its norms is indeed an exemplary model of transnational arrangements, it has so far not really been tested.

As Davies (2000)²⁷ has pointed out, it is the fact of voluntary membership and the lack of a mandate that has led to the BCBS not being able to enforce its rules. As a consequence, there is a pressing need at the international level to take a fresh look at the institutional structure of international financial regulation.

The simplest way forward, is of, course a gradual expansion in the membership of the BCBS by taking in some non G-10 countries as its members which have demonstrated their keenness and ability to adopt international best practice and to shape the international agenda. Alternatively, the countries chairing the Regional Groupings could also be included as members. Since the Chair rotates among member countries, this would provide increased coverage in representation. Another more drastic variation could be that the BCBS be replaced by full-fledged body of International Bank Supervisors with membership of all nations, which would set standards, monitor compliance through empowered committees, like the IOSCO has done. The IOSCO too is a 'club' like the BCBS and the IAIS, but has around 150 member countries and operates through several committees wherein the Chair is rotated. IOSCO's members come from a variety of different places, including national securities commissions, stock exchanges and international and regional organisations. IOSCO focuses primarily on encouraging the development of common accounting standards that issuers of

securities can employ to offer stock in multiple countries without having to comply with the separate disclosure requirements of each (Table 2).

Table 2: Key Standards in Financial Regulation and Supervision

Area	Key Standard	Issuing Body
Banking	Core Principles for Effective Banking Supervision	BCBS
Securities	Objectives and Principles of Securities Regulation	IOSCO
Insurance	Insurance Core Principles	IAIS
Conglomerates	Supervision of Financial Conglomerates	Joint Forum

Another variant could be that the BCBS as it exists, with some representation from the non G-10, could be responsible to a larger body. The larger body could be the regional groupings of national supervisors, with each of these being represented on the Committee. Alternately, it could be a body like the IMF, which already has a membership of nations, a stake in financial sector surveillance and which is developing the skills in bank supervision.

Probably what is more crucial at this stage is not the final solution but simply the fact that the membership issue needs to be brought to center stage. This debate will also lead to a focus on the need for a clarity of roles amongst the different international bodies which are now involved in some manner with the supervision of the financial sector and lend strength to the Basel Committee's role as standard setter.

The globalisation of banking operations and the attendant crises has meanwhile shifted focus to what is popularly called the 'international financial architecture' (Kenen, 2001)²⁸. Attention has come to be focused on three interdependent sets of issues: crisis prevention, crisis management and crisis resolution. Commentators have suggested a gamut of solutions to tackle the problems. With respect to crisis prevention, proposal has been advocated to establish an international super-regulator. As for crisis management, recent suggestions include the creation of an international authority for insuring international investors against debt defaults (Fischer, 1999)²⁹. And finally, in the area of crisis resolution, there have been suggestions regarding the constitution of a global restructuring agency and an international bankruptcy court. As evident,

the range of proposals is varied, covering diverse areas, ranging from creating a new body for international regulatory oversight to an international LLR to integrating all the existing clubs and bodies under an umbrella organization (See, for instance, the discussion in Rogoff, 1999)³⁰. What should not get lost in the debate is that the bank supervisors from developing/emerging economies need to have a greater representation in the final format, since eventually the responsibility for the soundness and stability of the banking system is ultimately placed at their doors.

While the debate may have begun on the evolution of the new supervisory architecture, a prominent question that has come to the forefront has been the role of the official *versus* the private sector in dealing with financial crises. The large official support packages of the late 1990s (US \$48.8 billion for Mexico in 1995, US \$17.2 billion for Thailand in 1997, US \$42.3 billion for Indonesia in 1997, US \$58.4 billion for Korea in 1997 and subsequently, US \$41.6 billion for Brazil in 1998) prompted critiques that such public support created moral hazard. The bilateral contributions for Korea and Indonesia were only a “second stage backup”. The inadequacy of the financing provided in East Asia has been identified as one of the reasons why the IMF programmes did not succeed in stabilising the situation in the initial stages (Lane *et al.*, 1999³¹). With the role of the IMF fairly circumscribed due to its usable resources (around US \$150 billion) being well short of the external debt of developing countries, estimated at well over US \$ 2 trillion (Clementi, 2000)³², observers have suggested that there should be more ‘private sector involvement’ in financing crises (Haldane, 1999³³; Roubini, 2000³⁴) and in the same vein (Eichengreen, 1999³⁵) have advocated improving crisis resolution mechanisms through changes in the law governing private debt contracts, or through officially sanctioned standstills as a way to resolve investor panics. A more recent proposal for an international (quasi-) lender of last resort is outlined in Lerrick and Meltzer (2003)³⁶. Suggestions have also been offered regarding a ‘middle way’ between full IMF insurance and no insurance at all (King, 1999)³⁷, which has also not been without its detractors (Krugman, 1999)³⁸. From the supervisory standpoint, the banking system has stated that they do not

intend to take any responsibility for financial crises. The view to this effect is evidenced from a communication by the Institute for International Finance, a Washington-based lobby group of major international banks, to the IMF, which observed that banks and governments have distinct responsibilities: banks have only the responsibility to increase shareholder value and make profits out of capital, governments have the responsibility for financial stability and promoting social objectives. This, in effect, has prompted supervisory authorities to demand greater transparency by improving data from governments to international financial operators so as to improve 'market discipline' whereby financial operators would be able to detect the problems in time to change their risk-taking and avoid a crisis (Flannery, 1998)³⁹. Pertinent to mention in this context that the issue of disclosure and market discipline has been prominent in the analysis of, and the recommendations to deal with, hedge funds (and the more general highly leveraged institutions). While work on this front has been underway at the Basel Committee on Banking Supervision (the Brockmeijer Report), more definitive answers to the problems of high leverage are being sought by the FSF.

IV. POLICY CONCERNS

While the role of standard-setter has been thrust upon the Basel Committee and the IMF has come to acquire the role of the global supervisory authority by monitoring compliance with best practices, the testing ground for these roles could be manifested in two areas of recent focus - the implementation of the New Capital Accord and the concerted action against money laundering by the international financial system.

Issues with regard to the latter are still emerging, but they largely center around the question of the domain of operations of different agencies, with rules and guidance coming out of the Basel Committee, the Bretton Wood institutions, the Financial Action Task Force and other voluntary inter-bank initiatives. The issues have become further complicated by the fact that the target group of the regulations are not just banks and the supervisory concerns are to be addressed not only by supervisors of the bank and non-bank financial system, but also by

the Ministries of Finance and their Financial Intelligence Units (FIUs). The IMF has been working on a scheme to streamline the reporting methodology for Anti Money Laundering (AML)/Combating the Financing of Terrorism (CFT), which seeks to improve upon its earlier methodology, which would, in essence expand its surveillance agenda.

In comparison, the issues with regard to the New Capital Adequacy framework are better-enunciated and understood. The multi-layered structure of the proposed capital standard, with a variety of approaches to accommodate banks and jurisdictions with varied resources, expertise and risk profiles, has become a source of debate. To elucidate, the centerpiece of the proposal is to base the risk weights for assigning capital to bank assets based upon either ratings awarded by external ratings agencies or the internal rating based (or IRB) approach. Most developing countries have not developed external ratings infrastructure and the penetration of ratings among bank borrowers is very low, and hence their banks cannot benefit from the additional risk sensitivity provided by the former. Under the IRB approach, the regulatory capital requirement would be based on a bank's own internal assessment of each borrower's credit quality. Under this approach, a bank would need to have several core inputs for each credit facility: the probability of default (PD) for borrowers assigned to each internal borrower grade; the expected loss rate, given a default (LGD), appropriate for each type of exposure; the expected amount of exposure at default (EAD) for each type of exposure and the associated capital to meet selected solvency standards, reflecting undrawn credit lines and the maturity of the exposure. The supervisors will evaluate the risk-classification and risk-estimation processes at each bank using the Advanced IRB approach and if the processes are found to be acceptable, those classifications and associated capital needs will be the basis for minimum regulatory capital requirements. The implementation of such sophisticated processes will impose requirements on banks and more so on the supervisors to validate and guide in the development of IRB models as also provide PD, LGD and EAD estimates for different approaches and ensure consistency in the ratings given by the rating agencies. The new Accord has

proposed that the risk weights would be based on the borrowers' *external* credit ratings, when available. This, in its wake, would demand high degree of supervisory skills. Both the paucity of skilled supervisory resources and the lack of data and information systems in banks in developing countries implies that banks in several jurisdiction might not be in a position to implement the new framework. This in turn, could lead them to be assessed as non-compliant with the Accord and bear the consequences of such assessment in the international markets. This situation does not compare favourably with the existing position. The 1988 Accord, which was to be applied by Basel member countries by 1992, has become a *de-facto* international standard with a majority of supervisors having taken steps to implement this in the last decade.

Apart from the issue of non-compliance and its attendant problems, recent literature on the subject has also drawn other scenarios which could affect banks in non G-10 jurisdictions. One hypothesis is that lending to the developing world could decrease. Alternately, since the calibration of risk weights is considerably finer than that of the 1988 Accord, especially under the IRB approach, this could raise the cost of capital under this approach. Since most leading international banks could be expected to follow this approach, this would lower incentives for banks to lend to these countries. Another hypothesis goes further to suggest that developing countries could hanker for their own Accord because of the inability to apply the proposals in the new framework! Of course, there is no evidence to suggest that either of these two scenarios could play out in the future, and in fact the real headaches for bank supervisors could come simply from the cross-border implementation issues. As it stands, the new framework allows for many areas of national discretion and three clearly defined approaches. With the two hundred odd countries implementing a mix of the eligible approaches with different applications of discretion, there could be many areas of divergence between the treatment accorded to the same bank by home and host supervisors, which could impose additional costs upon the international banks.

Commentators have suggested some divergence in views within the membership of the Basel Committee itself with some national regulators

undecided on how widely to apply the Basel capital framework. In the words of Mayer (2001)⁴⁰, “the greater complexity of the new accord, at least with respect to the IRB options, suggests that it should cover a narrower range of banks: those that have been active pursuers of capital arbitrage, those that have made-or can make-the greatest advances in risk measurement and management, and those for whom the adequacy of the current standard is most in question”. The same view has been echoed by Schroder, German Chancellor, who was reported to have observed that Basel II was “unacceptable to Germany” (*The Economist*, 2001⁴¹). This is reported to have to do with *Mittelstand*, the 3 million small and medium-sized companies that constitute the backbone of the economy. The Basel II formulae for credit risk are based on credit ratings applied to company debt, either by rating agencies or internally by banks themselves. Since this is not the preferred method of rating adopted by the 2,800 odd German banks, equipping banks to adopt such rating procedures would drive up their cost of lending. With the Basel membership being divided on the scope and applicability of the new Accord, there seems to be a greater need than ever before for a consensus from the rest of the world, implying, in other words, a greater say of the non G-10 countries in the initial stages of operationalisation of the new Accord.

At a time when there is still limited information as to what constitutes international best practice despite the flagship work done by the BCBS and few internationally agreed standards, it remains a moot question whether sophistication in these standards could impair their universal application. What is for certain that the national supervisors continue to look upon the Basel Committee to set standards which will be globally relevant and take into account the differences in the stages of development of the banking systems and supervisory capabilities in the developing world. While the BCBS has walked this tightrope with élan till now, the events of the next few years will decide whether membership issues could affect the assimilation of international standards in bank supervision.

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